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Federal Communications Commission

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JUN 17 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 92-266
Rate Regulation	)	
Further Notice of Proposed Rulemaking	)	

COMMENTS
OF
TIME WARNER ENTERTAINMENT COMPANY, L.P.

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June 17, 1993

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Daniel Kelley, "Economic Issues Raised by the Further Notice," June 17, 1993.

Lewis J. Perl, Linda McLaughlin, and Jonathan Falk, "Econometric Analysis of the FCC's Proposed Competitive Benchmarks," June 16, 1993.

SUMMARY

Time Warner strongly opposes the Commission's proposed exclusion of cable systems with penetration rates below 30% in calculating its competitive rate differential.

As a matter of policy, the proposed exclusion threatens a substantial diminution in consumer welfare, the stifling of the cable industry's ability to attract investment, and the significant impairment of infrastructure development in direct

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COMMENTS OF TIME WARNER ENTERTAINMENT COMPANY, L.P.

Time Warner Entertainment Company, L.P. ("TWE"), by its attorneys, hereby files its comments in the Further Notice of Proposed Rulemaking in Docket No. 92-266, Cable Rate Regulation.[1] TWE opposes the proposal of the Further Notice to modify the Commission's rules to require further rate reductions as contrary to law, policy, and accepted economic science.

The Rate Order established "benchmark" rates for cable basic services and cable programming services in an effort to establish "reasonable" rates for these services. The benchmark tables are based upon an econometric analysis purporting to

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1 See Implementation of Rate Regulation Sections of the Cable Television Consumer Protection and Competition Act of 1992, Report and Order and Further Notice of Proposed Rulemaking, MM Dkt. No. 92-266 (rel. May 3, 1993) ("Rate Order" or "Further Notice").

measure the differential between the rates charged by systems subject to "effective competition," as defined in the 1992 Act, and those charged by a random sample of "non-competitive" systems. From this analysis, the Commission calculated a 10% "competitive differential." In the Further Notice, the Commission questions whether it should issue new benchmarks, reflecting a 28% differential. The new results would derive from an exclusion of one statutory class of "effectively competitive" systems -- those with penetration rates below 30%. As discussed below, scientific, legal, and policy analysis will not support this further reduction in rates.

I. INTRODUCTION

At the outset, the Commission should appreciate just what is at stake in its current proposal. A substantial diminution in consumer welfare is already threatened by the current implementation of the statute by the Commission. The cable industry up to now has created and offered programming services that consumers value highly, and has produced jobs, investment, and increased the tax base. This proceeding could determine whether the cable industry will be allowed to continue in its success or be cut down to satisfy political appetites.

The cable industry's prospects for future growth depend critically upon its access to capital and, relatedly, upon a certain and stable regulatory environment. Reducing rates by 28% as the Further Notice suggests, however, could have a devastating impact on the continued ability of cable operators to attract investment.[2] This impairment has implications not only for the growth of programming services, but for future infrastructure development as well. In a paper entitled "Technology for America's Economic Growth, A New Direction to Build Economic Strength," issued on February 22, 1993, President Clinton and Vice President Gore outlined the necessity for such an information network and advocated a regulatory environment that would encourage private investment in the telecommunications facilities forming the network.[3] For the Commission now to propose additional action that could further impair and discourage infrastructure development would be wholly at odds with these established Executive Branch policy directives.

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[2] See generally, Abelson, "The Wind Blow Coalition," Barron's at 1 (June 7, 1993).

[3] See "Technology for America's Economic Growth, A New Direction to Build Economic Strength," President William J. Clinton and Vice President Albert Gore, Jr., at 7, 17 (Feb. 22, 1993).

II. THE COMMISSION CANNOT LAWFULLY ORDER FURTHER RATE REDUCTIONS BY EXCLUDING CABLE SYSTEMS WITH LESS THAN THIRTY PERCENT PENETRATION FROM THE DATA SELECTION PROCESS

A. The Terms of the Cable Act Defining Effective Competition are Binding on the Commission

In collecting data from "cable systems identified as likely to be operating in competitive markets,"[4] the Commission set out to apply each of the three statutory criteria for determining the presence or absence of "effective competition."[5] Divining now that "the low penetration of cable systems in some areas may be attributable to factors other than the presence of competing video distribution services,"[6] the FCC here questions whether the exclusion of data collected by "below-30" systems may produce a better measure of the competitive rate

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[4] See Implementation of Rate Regulation Sections of the Cable Television Consumer Protection and Competition Act of 1992, 8 F.C.C. Rcd 226 (1992) ("Rate Survey Order").

[5] Cable service rates are regulated under the Cable Act if the cable system is not subject to "effective competition." The Cable Act classifies a cable system as subject to "effective competition" if (A) fewer than 30 percent of the households in the franchise area subscribe to the cable service of a cable system; (B) the franchise area is (i) served by at least two unaffiliated multichannel video programming distributors each of which offers comparable video programming to at least 50 percent of the households in the franchise area; and (ii) the number of households subscribing to programming services offered by multichannel video programming distributors other than the largest multichannel video programming distributor exceeds 15 percent of the households in the franchise area; or (C) a multichannel video programming distributor operated by the franchising authority for that franchise area offers video programming to at least 50 percent of the households in that franchise area. Communications Act § 623(b)(1), 47 U.S.C. § 543(b)(1). Thus, cable systems are immune from rate regulation if they meet any one of these statutory standards.

[6] Further Notice, at ¶ 561.

differential. TWE fully sympathizes (albeit for very different reasons) with the view implicit in the Further Notice, that is, that the legislative definitions may not reflect the true competitive constraints under which cable operators must perform. But the suggestion that the FCC can disregard the plain statutory language because in its own view Congress erred in not crafting better measurements is blatantly illegal.

The Commission is lawfully bound by the statutory definition and cannot simply ignore it to achieve a certain result.[7] As a well-settled rule of administrative rulemaking dictates, agency decisionmaking must "be true to the congressional mandate from which it derives authority."[8]

It is well understood that in enacting its own definitions in the 1992 Act, Congress was expressing its dissatisfaction with the FCC's definitions which had been promulgated under the authority of the 1984 Act.[9] Rather than

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[7] See Environmental Defense Fund v. E.P.A., 852 F.2d 1316, 1326 (D.C. Cir. 1988) cert. denied, American Mining

leaving it to agency discretion, Congress gave specific instruction to foreclose the agency from reaching results at odds with the legislative plan. The legislative history confirms what is apparent on the face of the statute.[10] Thus, "to be true to [its] Congressional mandate," the Commission must, as a matter of law, maintain definitions of effective competition consistent with each of the three statutory definitions. While the Commission could review specific observations and choose to discard those individual data as unreliable or erroneous, it cannot discard wholesale an entire category of systems which Congress has already determined to reflect effective competition

B. It would be Arbitrary and Capricious for the Commission to Apply the Statutory Definitions of Effective Competition to Some But Not All of the Data Selection Process

As discussed above, TWE believes that the Commission is without authority to substitute Congress' judgments with its own categories of "effective competition." Assuming arguendo that the Commission has such authority, however, the Commission could not lawfully choose to simply exclude all systems with less than 30 percent penetration without further analysis. Rather, a complete reevaluation of all of the data collected from the responding cable systems, as well as other potential sources of data not yet considered, would be required.

The Further Notice proposes to delete the below-30 systems because it questions the reliability of those observations. But there is no particular reason to "suspect" some of the data and be confident in others. As explained by Dr. Daniel Kelley of Hatfield Associates, Inc. in his attached paper, there is no basis for assuming that the rates for the below-30 systems are "too high" -- in fact, it may well be that the "overbuilds" are "too low."[11] The rates collected and categorized as "overbuild" survey responses may reflect disequilibrium conditions, that is, the presence of short-term price wars where rates are forced below cost and cannot be sustained over a longer term. If that is the case, it may well be that these rates are indeed below competitive levels.

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[11] Daniel Kelley, "Economic Issues Raised by the Further Notice," June 17, 1993, at 5 ("Kelley").

Similarly, as Dr. Kelley also explains, the large number of small systems in the below-30 category of observations may have yielded "high" prices as a reflection of system size. Thus, these "high" rates may indeed be at "competitive" levels, levels that reflect their higher costs.[12]

Even more troubling, the Commission's quantitative effort was, until the Further Notice, apparently quite exacting in its attention to the statutory definitions. For example, Appendix E explains that information collected from certain cable systems subject to effective competition under the second statutory definition (50 percent availability/15 percent share) were dismissed for purposes of calculating the benchmark rates due to the Commission's understanding of that statutory definition. Appendix E notes that information from 104 cable systems was excluded because it did not satisfy the strict terms the below-30 observations. If the Commission decides it can discard the below-30 observations, it must revisit the validity of all of the observations -- those used and those discarded -- and reconsider their use independent of the statute.[14]

The Commission would also be under an obligation to consider alternative means of calculating a competitive benchmark, and publish such alternatives for public comment.[15] Until now, the Commission had been adamant that there would be only one method by which a competitive benchmark could be calculated. The initial Notice asserted, without discussion, that it would define a competitive benchmark rate "using the average of rates currently charged by systems facing effective competition, as the Cable Act of 1992 defines that term."[16] This assertion also appears in the Order that asks cable operators to submit information on their rates and other cable system

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[14] See Farmers Union Central Exchange, Inc. v. F.E.R.C., 734 F.2d 1486, 1500 (D.C. Cir. 1984), cert. denied, Association of Oil Pipelines v. Farmers Union Central Exchange, Inc., 469 U.S. 1034 (1984) ("To acknowledge that circumstances have changed, however, is not to eliminate the burden upon the agency to set forth a reasoned analysis in support of the particular changes finally adopted").

[15] 5 U.S.C. §§ 553(b), (c). Cf. International Ladies' Garment Workers' Union v. Donovan, 722 F.2d 795, 815 (D.C. Cir. 1983) cert. denied Breen v. International Ladies' Garment Workers' Union, 469 U.S. 820 (1984) ("[W]e are constrained to hold that the Secretary's failure to consider such alternatives, and to explain why such alternatives were not chosen, was arbitrary and capricious....") (footnote omitted).

[16] See Implementation of Rate Regulation Sections of the Cable Television Consumer Protection and Competition Act of 1992, Notice of Proposed Rulemaking, 8 F.C.C. Rcd 510, 521-22 (1992) (emphasis added).

characteristics. Schedule 4 of the <u>Rate Survey Order</u> asks for information from the surveyed cable operators about forms of possible competition in any franchise areas in the system, but limits those "forms" of competition to the three statutory definitions.[17]

If the Commission now were to try to depart from the statute, it would need to consider numerous other reasonable approaches to defining effective competition. Indeed, the last time the Commission visited this issue in a quantitative effort, it concluded that the availability of six over-the-air signals would suffice to constrain the pricing practices of cable companies. On the basis of what evidence now could the FCC depart from these findings?

An agency in promulgating rules must employ "reasoned decisionmaking" practices and give consideration to all of the material facts and issues before it.[18] If the Commission here decides to dismiss information submitted by systems subject to effective competition under the less than 30% penetration definition without reevaluating all of the submitted data and considering alternative means of measuring effective competition, then it would be abdicating its administrative responsibility to

Commission has announced that it plans to undertake another survey, any revision to be considered must be done as part of that process, and not by the "amputation-without-anesthetic" approach suggested in the Further Notice.

C. Further Rate Reductions Would Be Contrary to Accepted Econometric Principles and Therefore Arbitrary and Capricious and Without Record Support

As discussed in Dr. Kelley's paper and in the attached paper by Dr. Lewis J. Perl, Linda McLaughlin, and Jonathan Falk of National Economic Research Associates, Inc. ("NERA"),[19] the FCC's quantitative efforts to study the cable industry in this proceeding have been fraught with technical and analytical problems. As Dr. Kelley states, "the econometric evidence in support of the 10 percent reduction is weak."[20] As these experts make clear, any further reductions made on the basis of the Commission's econometric work to date simply cannot be supported.

The Commission's statistical efforts must, as a matter of law, comport with accepted scientific standards. The Supreme Court in the past has rejected the application of flawed statistical analyses to important public policy issues. See, e.g., Ward's Cove Packing Co. v. Atonio, 490 U.S. 642 (1989) (reversing Court of Appeals due to improper statistical comparison in race discrimination case). Lower courts have also

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[19] Lewis J. Perl, Linda McLaughlin, and Jonathan Falk, "Econometric Analysis of the FCC's Proposed Competitive Benchmarks," June 16, 1993 ("NERA").

[20] Kelley at 1.

rejected comparisons that arbitrarily omitted, as the Commission proposes to do here, the "outlying" data in favor of more preferable observations. See, e.g., Major Coat Co. v. United States, 543 F.2d 97, 114 (Ct. Cl. 1976), reh'g denied, 549 F.2d 196 (1977) (price comparisons in excessive profits case held to be fundamentally skewed where only average and median profit industry figures dominated record). The Commission's analysis leading to a 28% reduction flatly violates these principles.

Dr. Kelley explains the numerous flaws in relying upon the benchmarks derived from the FCC's analysis. As he notes, the feasibility of such an imprecise effort could plausibly have been justified, at most, in the context of regulating directly only basic service tier rates. However, once the Commission (erroneously) ignored the distinct treatment of basic vis-a-vis cable programming services and opted instead for a "tier-neutral" approach,[21] critical safety valves which had once given comfort to the use of such a rough tool were eliminated.[22]

The Commission applied and utilized its data effort as if it could derive a precise price level that would be identified as "reasonable" without any real room for adjustment short of elaborate cost-of-service showings. As Dr. Kelley explains, however, the Commission could have chosen instead an approach that would have allowed a "zone of reasonableness." Such an

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21 See Rate Order at ¶ 389. TWE intends to petition the Commission to reconsider its Order in this critical respect.

22 Kelley at 2-5.

approach would have been far more consistent with the indisputable imprecision of the Commission's effort, and could have served as an important safety valve for errors resulting from that imprecision. Indeed, while the Order "finds" a 10% competitive differential, as Dr. Kelley explains, "it is impossible to reject the hypothesis that the 'true' difference between the competitive and the random sample firms could be as low as -3.6 percent."[23]

The problems with extending the current analysis to a 28% reduction are examined by Dr. Kelley. He notes the very small number of competitive systems; if the below-30 systems are removed, "rates for an entire industry will be based on the experience of less than 50 firms."[24] Even if one could ignore the remarkably heterogenous nature of the cable industry, the number is simply too small to be a reliable basis for regulating. And in fact, the courts have rejected statistical analyses in the past precisely because the sample used was too small. See, e.g., Package Shop, Inc. v. Anheuser-Busch, Inc., 675 F. Supp. 894, 951-52 (D. N.J. 1987) (comparison of prices in "competitive" and "non-competitive" markets in antitrust case rejected due to unjustifiably small sample).

Similarly, the NERA study discusses some of the fundamental problems in the Commission's methodology. All of the criteria NERA describes as crucial to a good econometric model

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[23] Id. at 3 (emphasis supplied).

[24] Id. at 2.

are in doubt here. Thus, for example, it identifies such problems as the accuracy of the data and the possible exclusion of additional variables that might be significant.[25]

Most specifically, the NERA analysis strongly suggests that the Commission's regression may well have been misspecified. NERA undertook an analysis to consider whether the competitive differential might vary according to system size, as measured by the number of subscribers. In other words, is the differential between competitive and non-competitive systems of one size class the same as the differential between systems of a larger size? The Commission simply assumed the answer to be yes. As it turns out, the answer is no.

Applying the Commission's analysis with size categories (above and below 10,000 subscribers), NERA finds that the competitive differential for large systems is only 3%. Applying the same analysis but also deleting the below-30 systems as the Further Notice proposes to do, the study calculates for the larger systems only a 9% differential, dramatically in contrast to the 28% differential yielded by the FCC's less-refined analysis. Further, using a weighted method to account for subscriber size differences to derive a single industry average, methods, each of which uses more refined and thus more reliable analysis, the Commission's conclusion of a 10% differential as an accurate industry average is put into serious question, and the tentative proposal to reduce the differential to 28% is thoroughly discredited.

The expert papers attached conclusively demonstrate that a 28% differential yielded by the Commission's initial efforts can no longer be seriously considered. The Commission's legal obligations to adhere to accepted statistical practice utterly preclude adoption of the Further Notice's proposal.

CONCLUSION

TWE respectfully urges the Commission to reject the proposal of the Further Notice. Such action cannot find any legitimate support in law, policy, or econometrics. It should, accordingly, be discarded.

Respectfully submitted,

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June 17, 1993

ECONOMIC ISSUES RAISED BY THE FURTHER NOTICE

Prepared for

Time Warner Entertainment Company, L.P.

By

Daniel Kelley

Hatfield Associates, Inc.

June 17, 1993

ECONOMIC ISSUES RAISED BY THE FURTHER NOTICE[1]

The Commission has established a benchmark based on the rates charged by cable systems subject to effective competition, as defined by the 1992 Cable Act. The Further Notice of Proposed Rulemaking asks whether systems with penetration levels below 30 percent should be deleted from the effective competition category for purposes of establishing benchmark rates. According to the Commission, the effect of ignoring these low penetration systems would be to reduce regulated system rates by 28 percent instead of 10 percent.

The Commission should not reduce the benchmark rates. First, the econometric evidence in support of the 10 percent reduction is weak. Moreover, the legitimacy of the entire econometric exercise is in doubt due to the decision to adopt "tier neutral" regulation. Any further rate reductions would exacerbate this problem. Second, if the Commission is going to adjust the Congressional definition of effective competition, then it should make a comprehensive evaluation of all of the effective competition systems. Third, alternate approaches to establishing the benchmark fail to support larger rate reductions. Fourth, the Commission must recognize that regulation can reduce consumer welfare. Further rate reductions without a thorough analysis of this issue are unwarranted. Finally, the effect of any additional reductions will inevitably be to increase, perhaps substantially, the number of rate cases. The Commission, local authorities, and cable companies will have to expend substantial extra resources to deal with these cases. Ultimately, consumers will bear both the public and private resource costs.

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[1] I submitted a statement in this proceeding at the Notice stage. See "Economics of Cable Television Regulation," January 27, 1993. A copy of my resume was submitted with that statement.

I. "TIER NEUTRAL" REGULATION MAKES THE USE OF THE EFFECTIVE COMPETITION BENCHMARK PROBLEMATIC

Although useful in many cases, econometrics is an inherently imprecise policy analysis tool. Imprecision in the Commission's attempts to estimate a competitive differential may stem from several sources, including specification and data errors.[2] Moreover, the analysis was necessarily conducted under extremely tight time deadlines, with limited data. If the low penetration systems are not used by the Commission, then rates for an entire industry will be based on the experience of less than 50 firms.[3] Further analysis is necessary to better understand cost drivers in the industry. It would not be appropriate to make valves" were built into the proposals to use econometric comparisons of effective competition and regulated systems to create benchmarks.

First, an interval rather than a point estimate of the basic service benchmark was proposed. NCTA, for example, suggested that the Commission establish a "zone of reasonableness" above the average or the median competitive rate to establish the benchmark.[5] The Commission used the mean of the effective competition systems to set the benchmark.

Using a zone of reasonableness to set the benchmarks is justified due to the inherent imprecision of the estimates. As the Commission reports, the 95 percent confidence interval around the point estimate of the difference between the random sample and the effective competition firms is quite large.[6] Using standard statistical methodology, it is impossible to reject the hypothesis that the "true" difference between the competitive and the random sample firms could be as low as -3.6 percent.

The Commission uses concepts similar to the zone of reasonableness in other contexts. For example, under the price cap rules, local exchange carriers are allowed to earn substantially more than the allowed rate of return without reducing their rates. Prior to price cap regulation, rate of return estimates themselves were set within a zone of reasonableness to reflect imprecision in the process of arriving at an allowed rate of return and to accomplish ancillary goals, such as encouraging efficiency.

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[5] Bruce M. Owen, Michael G. Baumann, and Harold W. Furchtgott-Roth, Cable Rate Regulation: A Multi-Stage Benchmark Approach, January 27, 1993, pp. 14-15 (filed with the Comments of the National Cable Television Association). As Owen et al note, "...to focus on the median competitive price is to lose sight of the fact that one-half of the competitive systems have rates above the median." p. 14.

[6] See Order, Appendix E, p. 13.

The practical effect of using the mean instead of the end point of a range of rates above the mean to establish the benchmark is that a large number of additional firms will be able to justify rates using a cost showing.[7] Of course, using a zone of reasonableness would increase the probability of allowing rates that are in some sense "too high" relative to the true differential between competitive and noncompetitive systems. There is an important policy argument in favor of erring on the side of allowing some rates that may be "too high." Consistent with the 1992 Cable Act, the enforcement burden would be minimized, while the rates that are most likely to be found unreasonable under a cost of service showing would be reduced.[8]

The second "safety valve" involved the use of separate regulatory standards for basic and cable programming services. The Act and the supporting legislative history clearly show that separate approaches for basic and cable programming rate regulation were contemplated.[9] Therefore, several parties suggested that regulation of cable programming service rates should focus on systems whose rates are significantly higher than the average. In effect, the suggestion was that the zone of reasonableness for cable programming services should be larger than the zone of reasonableness for basic service rates.

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[7] The decision to require a fixed 10 percent reduction for firms whose rates are more than 10 percent above the benchmark instead of a full reduction to the mean level reduces, but does not eliminate, this problem.

[8] Sec. 3(b)(2)(A) of the 1992 Cable Act requires the Commission to "...reduce the administrative burdens on subscribers, cable operators, franchising authorities, and the Commission."

[9] See "Economics of Cable Television Regulation," *supra*, note 1, pp. 9-16.

Given the diversity of the cable industry, the critical cost drivers for individual firms vary widely. Therefore, any single basic rate benchmark approach is likely to generate incorrect results for many systems. However, with the broader zone of reasonableness for cable programming services, cable operators might have the opportunity to earn a reasonable rate of return without having to resort to the necessity of both a publicly and privately burdensome rate of return showing. Again, the rates most likely to be found unreasonable through use of a cost of service standard would be reduced, while the public interest in reasonably priced basic cable services would be preserved.

II. IF THE BENCHMARK FIRMS ISSUE IS OPENED, THEN A COMPREHENSIVE ANALYSIS OF ALL OF THE EFFECTIVELY COMPETITIVE SYSTEMS IS NECESSARY

The Comments noted several potential problems with the effective competition benchmark. For example, the rates for many overbuild firms could be below competitive levels due to disequilibrium conditions such as price wars.[10] If the issue of which firms belong in the competitive benchmark category is to be opened, then such firms should be identified and their influence on rates removed from the benchmark. Similarly, within the low penetration category, it was noted at the Comment stage that some firms could have high rates due to their small size.[11] If the econometric analysis of the random sample firms used to identify significant cost drivers fails to adequately account for this phenomenon, then one of two alternatives should be pursued. These firms could be removed from the low penetration sample, even though they could be pricing competitively, that is, at levels reflecting

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[10] See, for example, *id.*, p. 24.

[11] *Id.*, p. 25.